

Assessing the financial implications of competition

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Introduction

We welcome the publication of Martin Cave's report on competition and innovation in the water industry in England and Wales. We agree that retail competition can be introduced relatively straightforwardly, but that it can only be a start. We also agree that a lot of preparatory work needs to be done before competition can be extended to other areas of the value chain. One of the critical areas to be understood is the actual, as opposed to reported, incidence of costs. I will return to this issue- but first some comments on the development of competition, the framework for innovation and the benefits to customers.

The introduction of retail competition for water and sewerage services in Scotland is already beginning to bring benefits to customers.

- The industry's costs are lower than they would otherwise have been;
- Levels of customer service and responsiveness have improved (eg multi-site billing, more tailored services and new tariffs)

We are confident that Scottish customers will increasingly benefit from choice and from the resulting innovation of market participants. We recently licensed a fifth entrant to the market and would expect more new entrants, both larger and smaller and we expect these entrants to identify further savings and improvements in service for their customers.

We will continue to take steps to strengthen the market framework. For example, we recently introduced the option of replacing pre-payment with a guarantee from a parent company or an appropriate insurer.

But we will also ensure that our regulation of the remaining monopoly elements of the industry adapts to changing circumstances but still remains robust, targeted and generates the right incentives for improving efficiency and innovation.

We opened the Scottish water and sewerage market to retail competition for all non-household customers on 1 April 2008. This market operates in much the same way as retail in other utility services. The new suppliers buy wholesale services, (the physical supply of water and removal of sewage) at regulated prices from Scottish Water.

There is also the option of a self-supply licence. A self-supply licence allows the holder to buy at wholesale prices from Scottish Water, but obviously he foregoes any of the convenience and services provided by the retailers. We have recently had interest in from two major companies.

Legal separation of the retail activities of Scottish Water from the wholesale activities has been critical. Any necessary interactions are covered in a published Governance Code. This separation has been critical to both the reduction of cost and improvements to customer service that have been achieved by Business Stream.

But this separation will require us to look again at how we regulate Scottish Water for the 2014-2019 price review. For this price review we have been able to use 2007-08 as a base year (when Business Stream still had 100% of the costs, activities and customers) and to recreate a virtual vertically integrated water and sewerage company. We are able to use a combination of Ofwat and Water Industry Commission benchmarking techniques, using information from the respective June returns of Scottish Water and the companies south of the border, to assess the efficiency challenge that we should apply to Scottish Water in setting charges.

By 2012/13-the likely base year for the 2014-19 regulatory control period, we expect that the retail market will have changed quite markedly and that the market share of Business Stream could have fallen materially. As such we may be unable to make comparisons with England and Wales in the same robust ways as currently- our ability to make comparisons would depend critically on how far the competition framework in England and Wales has developed.

In terms of our management of the licensing framework, the Commission is keen to allow licensed providers to influence how the market develops and the changes that should be considered. The Commission has set out what it sees as the key principles underpinning the market and would veto a potential change only if it ran counter to one of these principles.

In this regard, it is worth emphasizing that we see trading between Scottish Water and its subsidiary as no different to that between SW and any other licensed provider.

We regard it as vital that:

- wholesale charges in Scotland are published and are available to all retailers on a wholly non-discriminatory basis.
- the market framework is governed by a series of codes and standardised agreements. They provide all parties with clarity about their respective roles and responsibilities. This clarity avoids the need for protracted negotiations.
- A new organisation- the Central Market Agency administers the market codes, calculates wholesale bills and registers switches of supplier by customer.

We continue to work at aligning the incentives of market participants (both retailers and wholesaler) to innovate with the customer interest.

The Water Services Act 2005 allows new suppliers and their customers to benefit if they help Scottish Water to reduce its costs. Discounts may be available to organisations that can plan their water use or waste disposal (for example by restricting their use of water at certain times of day); there may also be opportunities for developers to work with Scottish Water and realise benefits. As such, it allows for innovation where this is economically justifiable. The potential is limited only by the scope for the customer to reduce Scottish Water's current or future costs.

Our work on introducing competition has consistently revealed that the true cost of potentially contestable activities is higher than initially expected (even by us as regulator).

Few initially accepted that the average gross retail margin (the difference between the default retail tariffs and wholesale prices) was between 10 and 11 percent. It is around 5% for all non-household customers in Scotland. We expect that margin to increase as further activities (currently in the wholesale business) become contestable.

We are now working to allocate the full economic costs to activities that may be contestable. Treatment of water and sewerage are areas where we see such scope. We need to ensure that a potential new entrant does not face a playing field that is tilted against him. Our provisional work in this area, which we will publish in our draft determination, casts some serious doubts on the traditional activity cost allocations conducted by the water and sewerage businesses. These typically show the water network business to account for in excess of 50% of the costs. In our view allocating costs on the basis of contestability may result in allocated network costs falling by nearly half.

We note the assertions of many companies that it is critical to divide up the RCV between different activities. We disagree. We consider that it is rather more important to understand the on-going costs of each potentially contestable activity, including the costs of finance. These can then be subtracted from the costs of the vertically integrated company.

Conclusion

We have successfully introduced retail competition in Scotland- but this can only be regarded as a first- albeit important- step in introducing competition to the water and sewerage industry.

We have begun to think about how we will regulate Scottish Water now that it is no longer a vertically integrated company and the straightforward (and vitally important) comparisons with the companies south of the border are no longer available.

We have also begun to think about extending competition and are already concerned that traditional cost allocations have little in common with the actual economics of the water and sewerage companies.